Reinsurance of VFA business

IFRS 17 prohibits the application of the VFA (Variable Fee Approach) to reinsurance contracts held which, in certain circumstances, creates an accounting mismatch between the underlying VFA compliant contracts and the reinsurance held.

In the UK, reinsurance contracts where the shareholders share of the underlying contract bonuses (with-profits) or the annual management charges (unit-linked), are transferred occur for commercial reasons and may be both internal to a group (often amongst IFRS reporting entities) or external. Whilst they are not frequently issued contracts, where they do occur they are often significant in scale and given the differences in the treatment of financial risks between the VFA and the GMM (General Measurement Model), they can create very significant accounting volatility where the financial risks on the underlying direct contracts are transferred by the cedant.

An example of the commercial rationale for when reinsurance of VFA business occurs

(1) Reinsurance prior to disposal

In the UK, there are several insurers with a business model that consolidates closed life funds, allowing them to access operational and capital synergies from pooling multiple closed books of business. The process of transferring a portfolio of contracts from one insurer to another is necessarily slow due to the complexities of ensuring appropriate policyholder protection (including court approvals) and the complexities of migrating the complete policyholder records to ensure appropriate continuation of service. Depending on complexity it can take a period of several years to complete a disposal transaction which is not viable from a commercial perspective. It is therefore important to ensure certainty of the economics of a transfer at the date of the agreement and this can be achieved via a reinsurance contract. A recent example of this is the reinsurance of Legal & General's mature savings book (including all with-profits business) in January 2018 for £650m, including the reinsurance of £7,136m of with-profits liabilities and backing assets. [See Legal & General 2017 annual report p210 and 196 - https://legalandgeneralgroup.com/media/2360/annual-report-2017.pdf]

Accounting Impact -explanation of the accounting mismatch that arises

To illustrate consider the implications of the above transaction where a direct insurer transfers all risks (insurance and financial) on a block of unit-linked business via a reinsurance treaty.

Within the cedant the gross liabilities are in-scope of the VFA under IFRS 17. The reinsurance asset in the cedant and the (re)insurance assumed liability in the reinsurer are in-scope of the GMM as IFRS 17.B109 stipulates that reinsurance ceded and assumed cannot be insurance with direct participating features.

If due to favourable investment performance of the underlying items, unit prices increase:

Under the VFA the gross liability increases by an amount equal to the increase in the underlying items. **Hence there is no impact on the cedant net equity before reinsurance.**

The reinsurance asset increases, but because it is measured under the GMM, the reinsurance CSM is not adjusted for the increase in the reinsurers share of the underlying items. The reinsurance asset increases by an amount equal to the increase in the underlying items less the increase in the reinsurer share of the variable fee, **and so there is a reduction in the cedant net equity due to the reinsurance, creating a mismatch which does not reflect the fact that all risk has been transferred.**

Proposed Solution

The significant accounting volatility as described above could be addressed by allowing the cedant and the reinsurer to account for reinsurance contracts held / issued using the VFA when such reinsurance contracts involve transfer of the insurance and financial risk of the underlying directly participating insurance contracts. We are of the view that this would increase the relevance and faithful representation of information in the financial statements of entities that issue insurance contracts and will also aid understandability.